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Testimony before the U.S. Trade Deficit Review Commission

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Dr. Weidenbaum and members of the Commission, thank you for inviting me here to brief you on the impacts of Canada-U.S. trade liberalization and the challenges faced by U.S. businesses in responding to freer trade. My discussion will emphasize the following points:

1. When thinking about the merchandise trade deficit, it is important to consider the *microeconomic* activities that underlie these numbers. On the production side, U.S. and foreign firms make decisions about locating production, and these decisions often entail significant transfers of goods--final and intermediate--to and from home and foreign markets. Increasingly, these transfers are becoming part of our merchandise trade balance. Specifically, a growing volume of international trade is **intra-firm trade**, conducted within different operations of the same multinational firms. In any given year, a large fraction of total U.S. imports of goods come from the foreign affiliates of U.S. multinational companies (MNCs). For example, in 1992, U.S. imports of goods from American foreign affiliates amounted to \$83.2 billion, (approximately 16% of total U.S. imports). In the same year, exports from U.S. parent companies to their foreign affiliates totaled \$100.7 billion--22.5% of total U.S. merchandise exports.

The figures for trade with Canada are even more striking. In 1992, 37% of total U.S. merchandise *imports and exports* to and from Canada were shipped intra-firm between U.S. parent companies and their Canadian affiliates. (Intra-firm trade with Canada accounted for 44% of total U.S. imports from affiliates and 34% of total U.S. exports to affiliates in 1992).

2. Trade deficits are often interpreted as a decline in global competitiveness. But in the case of the U.S., the issue is complicated by the extensive role of affiliate trade in U.S. imports. This is particularly the case with U.S.-Canada trade. Trade liberalization between the U.S. and Canada has led to significant increases in bilateral trade, much of which is intra-firm.

3. Because of historically high Canadian tariffs, foreign firms wanting to gain access to the Canadian market have typically been forced to build plants in Canada. Although many U.S. manufacturers could have served the Canadian market from the U.S., it was often cheaper to produce in Canada than to export from the U.S. and pay the high Canadian tariff. In Canada, high tariffs created a domestic "branch plant economy" in which manufacturers tended to produce a wide variety of products, which were expensive by international standards. Manufacturing facilities designed to serve the Canadian market were typically too small to achieve efficient scale production.

Why is this relevant to the U.S. economic situation? Many of the inefficient “Canadian” manufacturers were actually affiliates of U.S. multinational companies! Indeed, although foreign ownership of Canadian manufacturing capacity has declined considerably, after peaking at approximately 60% in 1970, it remains close to 40%, of which the majority is U.S.-owned. Prior to trade liberalization, many of the U.S. multinational affiliates in Canada functioned as “mini-replica” plants. In other words, their Canadian facilities looked very much like small versions of their U.S. facilities, despite the fact that the Canadian market was a tenth the size of the U.S. market! Canadian operations typically manufactured small quantities of many different products and maintained full complements of administrative and management personnel. In effect, high Canadian tariffs can be viewed as a tax on cross-border shipments in that they forced U.S. companies to organize production inefficiently.

4. Trade liberalization between the U.S. and Canada has allowed U.S. multinational companies to produce more efficiently by integrating their operations across both markets. This integration has resulted in increased bilateral trade, as firms have rationalized production by reducing the number of varieties produced in each plant and increasing plant-level economies of scale. Since many products that had previously produced in both markets are now produced in only one market and shipped to the other (which is now possible due to lower tariffs), trade liberalization has necessarily led to more trade between both countries. This pattern began in 1965 when the Auto Pact liberalized cross-border shipments of motor vehicles and parts, and automobiles now constitute the largest single component of U.S.-Canada trade. Most of the trade in this sector is conducted intra-firm.

5. My research has focused specifically on the impact of U.S.-Canada trade liberalization on the production location decisions of U.S. multinationals and their Canadian affiliates. These decisions include choices on where to locate capital and labor and how much to produce in each location and ship intra-firm. I look at these decisions over a ten-year time frame that includes tariff reductions from the GATT and the Canada-U.S. Free Trade Agreement. My aim is to understand the kinds of restructuring activities multinational companies undertake to integrate production when tariffs no longer serve as an impediment to cross-border transfers. In one study (Please see my attached paper “U.S.-Canada Trade Liberalization and MNC Production Location”), my co-author, Michael Keane and I look at how four trade flows changed with lower U.S. and Canadian tariffs. Specifically, we look at trade to and from U.S. parents and their Canadian affiliates, arms-length sales by Canadian affiliates to the U.S. market, and Canadian affiliates’ sales in Canada. Overall, we find that trade liberalization led to greater Canadian affiliate sales to the U.S. (both to parents and others), and greater U.S. parent sales to Canadian affiliates. Indeed, Canadian affiliate sales to U.S. parents as a percent of total affiliate sales increased from 8.36% in 1983 to 10.47% in 1992. Similarly, U.S. parent sales to Canadian affiliates as a percent of total affiliate sales increased from 9.5% in 1983 to 12.87% in 1992. In a companion study (Please see my attached paper, “Trade Liberalization and Delocalization”), we look at the impact of bilateral tariff reductions on the employment and capital allocation decisions of U.S. multinational parents and their Canadian affiliates. We find that lower U.S. and Canadian tariffs were associated with higher levels of U.S. parent employment and higher levels of employment and capital investment in the Canadian affiliates of U.S. MNC parents.

The two studies point to a complex pattern of firm-level responses to trade liberalization, in which U.S. multinational companies, which had initially had mini-replica plants in Canada reconfigured their production in both the U.S. and Canada to serve both markets more efficiently. Overall, this restructuring meant that U.S. multinationals were increasing their specialization of production in each location.

6. In interviews with managers at U.S. multinational affiliates in Canada I conducted in 1996, I gained some qualitative insights into the kinds of restructuring multinationals undertook when trade was liberalized. The companies I studied both significantly downsized the administrative and management personnel at their Canadian operations and moved these activities to the U.S.. Then, decisions were made on a plant-by-plant basis, considering factors like plant age, installed machinery, location and capacity. One company focused on re-configuring its Canadian operations to produce small-batch orders for global export. Another company simply discontinued production of many product varieties in its Canadian plants and now buys products it no longer makes in Canada from its U.S. parent. Managers emphasized how important it was to their global operations to be able to integrate in North America. A larger, more efficient, integrated home market can enhance the worldwide competitiveness of U.S. companies that compete in global industries.

7. I conclude with a point I brought up earlier. To associate trade deficits with declining global competitiveness is to greatly simplify the microeconomic processes that underlie the numbers. As I have pointed out regarding trade between the U.S. and Canada, at the very least, we need to consider the role of intra-firm trade in U.S. merchandise imports and exports. In the U.S.-Canada case, trade liberalization enabled U.S. multinational companies with affiliates in Canada to restructure in ways that made them more competitive in North America, and possibly, in other markets as well. Giving U.S. companies the means to produce more efficiently, both in the U.S. and abroad, should by no means entail a "hollowing out" of U.S. industry--in the same way that Canadian tariff reductions have not brought about such a pattern north of the border. Lower barriers to trade do enable companies to restructure and reorganize, in ways that typically create more trade, both to and from the U.S.. Regardless of the net effect of this restructuring on the trade deficit, increased intra-firm trade implies that U.S. multinational companies are organizing their production more efficiently. At the firm level, this should lead to more--not less--- globally competitive U.S. multinational companies.